RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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April 4, 1984 LETTER 884

March 23 DJIA 1154.84; PTI 1696; A-D Ratio -18.60
March 30 DJIA 1164.89; PTI 1692; A-D Ratio -18.28

THE PICTURE: "To know values," wrote Charles Dow, "is to know the meaning of the market." At present real interest rates (current interest rates minus the inflation factor) are running near their highest level in history. For this reason I have included a special section on municipal bonds in this Letter, and I feel that Muni bonds now offer outstanding value for a large segment of my subscribers (certainly those near or at the 50% tax bracket).

As for the stock market, it's been over-sold since February 23. In the last Letter I noted that the "PTI has now reversed its current steep declining trendline, and trading purchases might be warranted here." Following that Letter the PTI dropped to a new low of 1693 (see page 2 chart) but on the new spill the PTI halted its decline above the trendline. The PTI looks as if it is trying to arrest its downside momentum, but I've learned not to try to outguess the PTI. I let it tell its own story.

On the point & figure chart (page 2) the PTI looks quite toppy, and if you remember, my "count" or projection based on P & F work is for a decline in the PTI to at least 1668. We aren't there yet, so my cold appraisal of the PTI is that it is traveling below its 21-week moving average, it looks toppy on the P & F chart, and the trend is still decisively down.

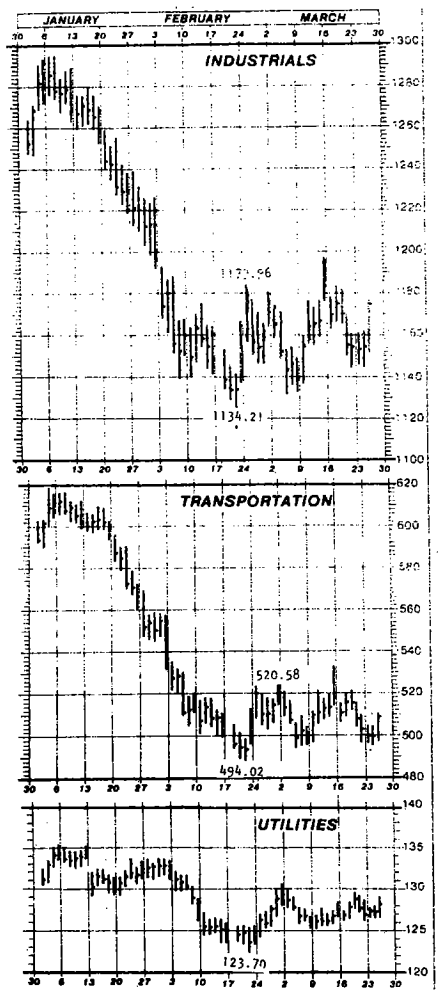
Over the past 12 years since the inception of the PTI, that indicator has been remarkably free of whip-saws (although one occasionally occurs). The PTI topped out on November 29 at 1796 (page 2 chart). It formed its initial downward slanting trendline on January 17 when a lower top appeared at 1787. In retrospect, that probably was the place to lighten up or exit from the market. On February 6 the PTI broke below its 21-week MA, and that was the definite signal to move out of the stock market, since at that point there was no questioning the major reversal formation in the PTI.

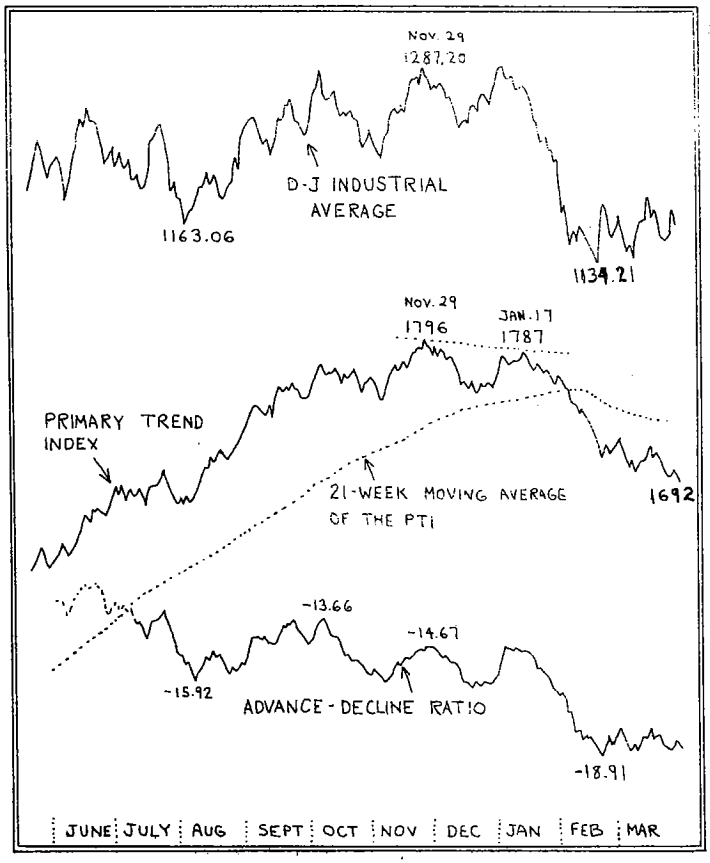
We might as well, at this point, review the topside and bottomside ranges of some of the important market indicators. On the *topside,* we have the PTI at 1796 (Nov. 29), the A-D ratio at minus 12.96 (June 16, and I think we can forget about seeing that A-D high for a long time to come). We also have the Dow high of 1287.20 (Nov. 29), the D-J Transport high of 612.63 (Jan. 9), the NYSE Composite high of 99.63 (Oct.10) and the S & P 500 high of 172.65 (Oct. 10).

On the downside we have the PTI at 1692, the A-D ratio at minus 18.91, the Dow Industrial Average at 1134.21 (Feb. 22), and the Transports at 494.02 (Feb. 23). Finally the D-J Utilities' low is at 123.70 (Feb. 23). The way things look at this writing, I would guess that the downside is going to face the first test and that test may not be far away.

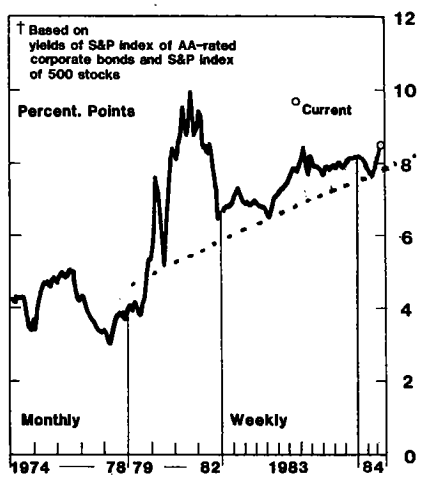
Remember this. I can't prove it's a primary bear market yet, but the sinking PTI makes me suspect that it is. If we are in a bear market, then TIME is working against equities (since values diminish as conditions deteriorate during a bear market). The A-D ratio peaked and turned down last June, almost nine months ago. Nine months is a rather long time for a bull market reaction (although there have been some that lasted longer). But if, in fact, we are in a bear market, then we are also nine months into a bear market. If that's true, we can expect the bear to exert a tightening effect *as time passes.* Thus, a further break by the Averages to new lows (below the February lows) would solidify my suspicions that a primary bear has Wall Street in its grip at this time.

A comment about the bond/stock yield differential should be instructive here. This chart (from S & P's The Outlook) shows that the yield spread in favor of bonds over stocks is now near 9%. I've never seen a *major* stock market advance start with that



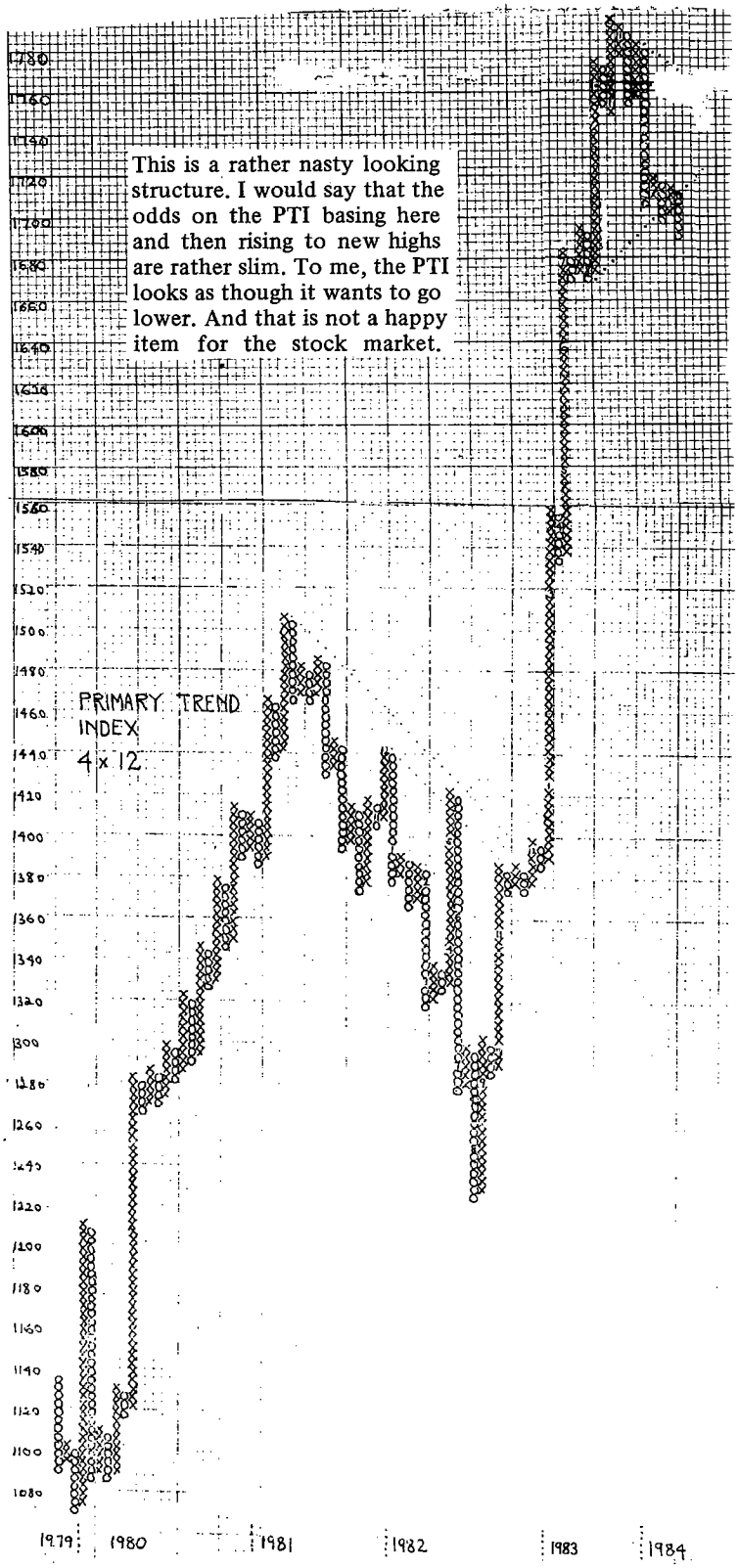


Difference in Yields in Favor of Bonds over Stocks.

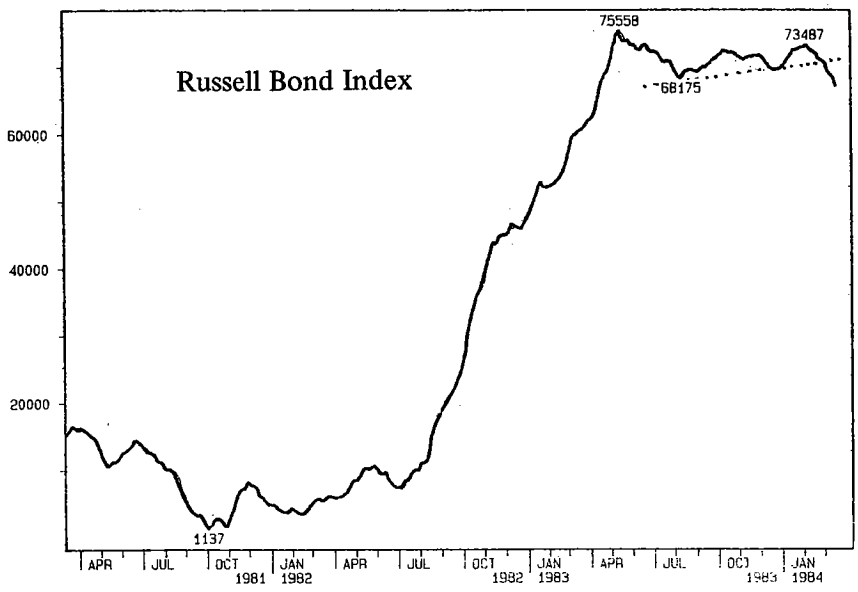


high a yield spread. I have drawn a rising trendline starting in 1980, and note that the yield spread has been fluctuating ABOVE this dotted trendline ever since 1980. Currently, the yield spread (in favor of bonds) would have to break below 8% on the trendline to reverse the situation. The fact is that yields on stocks and bonds have seldom been more out of kilter than they are now.

Another way of viewing this picture (and my thanks to Peter Bernstein on this) is that the yield spread between bonds and stocks is the hoped for "growth factor" in stocks. In other words, if stock earnings and dividends grow fast enough, then in due time stocks will end up (and even surpass) bonds from a return on investment standpoint. Can the future of stocks be as good as the current bond/stock yield spread indicates? Personally, I am very, very dubious.


This is a rather nasty looking structure. I would say that the odds on the PTI basing here and then rising to new highs are rather slim. To me, the PTI looks as though it wants to go lower. And that is not a happy item for the stock market.
PRIMARY TREND INDEX
4 x 12
1979
1980
1981
1982
1983
1984

Another problem in the current situation is that the trend of bonds is now down. Thus, the longer-term direction of interest rates is up, and this means continuous pressure on the bond/stock yield spread (in favor of bonds). I am showing here my Russell Bond Index, updated (thanks to the computer of subscriber John Carder). This index adds the daily advances and new highs minus the daily declines and new lows from the NYSE bond transactions. The chart shows the long-term trend of bond prices, and as you can see the trend now seems decisively down in favor of lower bond prices and higher bond yields. Of course, trends



can change at any time, but taken at face value, it would be hard to say that this chart allows for an explosion in bond prices with an accompanying collapse in bond yields.

Thus, the bond/stock yield situation further fortifies my guess that we have at this time a ceiling on stock prices. On the other hand, the sold-out condition of the stock market on February 23 provides some kind of a floor.

INVESTMENT POSITION: With the PTI below its 21-week moving average, our investment position is to be basically "on the sidelines." For those in higher tax brackets who want to purchase municipal bonds (and I recommend AA rated), plan a buying program spread over the next 12 to 15 months with equal portions purchased say every three months. I believe that the debt and interest rate picture could climax between now and mid-1985, and the average bond yields over the next 15 months will (in retrospect) represent great values. I will go into all this in much more detail in the next Letter).

A LIFE OF ITS OWN: One of the phenoma that always fascinated me is the syndrome wherein an item takes on a life of its own. We see this in the disease of cancer and mental diseases such as paranoia or schizophrenia. In these cases the disease progresses to the point where it seems to consume the person. The disease seems to become literally bigger than the person himself.

In the case of many cancers, for instance, the disease takes over the body, it spreads, it takes on a life of its own. And in the end the disease kills itself because it kills the body. The cancer only ends when it destroys its host–thereafter destroying itself.

The phenomenon of a "life of its own" extends into many social and political areas. In fact, there are three areas of modern life that I want to discuss. These three are (1) The arms race, (2) the legal area, and (3) the tax area. These three have, in my opinion, gone so far that they have built a huge vested interest and therefore have quite literally taken on lives of their own.

I have already (in this Letter) discussed the insane taxing area. The legal area, I feel, is moving towards insanity in this country. The glut of lawyers in the US is now almost laughable. There were 277,000 federal lawsuits in the US last year (triple the 1983 figure). There were 12.6 million civil lawsuits filed over the last year. Suing someone has become a national way of life.

As far as the military is concerned, the vested interest here is beyond belief. The biggest US export items are now food and military hardware. I'm not saying that the military explosion is strictly our fault. Russia seems on an unstoppable military binge. We are trying to keep up with Russia in some military areas, trying to pass Russia in others. But I feel that the whole military effort has now taken on a life of its own. How will it end? In the financial exhaustion and bankruptcy on both sides? Will it end in war? Obviously no one knows, but the military build-up seems almost unhaltable. And there is a growing number of people who don't want to stop it. Their jobs depend on it.

When something takes on a life of its own, how does it end? In my studies of this phenomenon, I would say that the end comes in climax, in exhaustion, in the breakdown (or death) of the entity that produced the insanity in the first place. But in almost every case, the original phenomenon goes to extremes. So put me down this way–I hate the whole military build up (on both the US and Russian side), I hate almost all lawsuits, and I hate almost all taxes. They are three of the great cancers in the US today.

MUNICIPAL BONDS: With the Bond Buyers 20 Municipal Average now yielding 10%, the whole question of municipal bonds becomes extremely interesting, and I want to bring the concept of Munis to my subscribers.

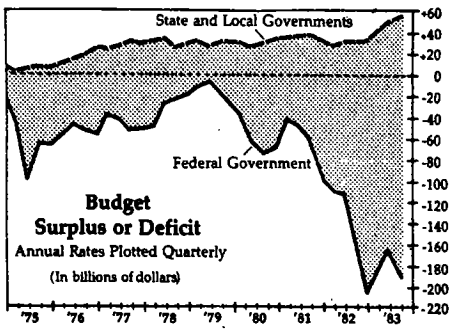
Here are some of the points I want to make. (1) On a Muni bond you pay no Federal tax. If the Muni is issued by your own state, then you pay no state or federal tax.

(2) The top-grade Munis (investment grade) are rated AA or AAA by S & P. I would stay with these two rated bonds, but AA is good enough for me.

(3) There are a number of kinds of Muni bonds, but the type I personally think is safest is the state general obligation (GO) bond. These bonds have the full faith and taxing power of the state behind them. The ratings of the various states vary (for instance, California is AA, Maryland is AAA, Michigan is only A+, New Jersey is AAA, New York is A+, Texas is AAA).

(4) Within each state dozens of different types of Muni bonds exist. An A+ rated state may have bonds rated AAA. But I still prefer the bonds of states rated AA or better.

(5) How safe are the Muni bonds? Possibly safer than Treasury bonds (except that the states cannot issue paper to cover their interest costs, while the Treasury can). Here's a WSJ chart showing the comparative financial situation of the states vs. the Federal Government. The chart speaks for itself.



(6) Why am I writing about Muni bonds now? First, AA-rated bonds from a state like California now yield around 9.5%. At this rate money doubles in eight years. Now follow this: You put $10,000 in a California state bond yielding 9.5%. In eight years you have $20,000. You have paid no federal tax on your interest and if you live in California you have paid no state tax. The money is all yours.

Let's say you put your money into a Treasury bond (10 years) at 12% yield. In the same eight years you will end up (if you are in the 35% tax bracket) with $18,236. If you are in the 50% tax bracket you will have $15,938. The Munis, in other words, put you well ahead of the Treasury bonds.

Now let's say you put $10,000 in the D-J Industrial Average. What happens in eight years (during which time your 9.5% Munis have doubled)? With the Dow at roughtly 1160 today, I estimate (including dividends and taxes) that the Dow would have to advance about 235% to equal the doubling in the Muni's (figuring in taxes on dividends and capital gains at the end of the eight years). Thus, as a rough figure I estimate that the Dow would have to be 2725 at the end of eight years to equal the tax free action of the 9.5% Munis. This could happen, but it is a tall order.

(7) There is another consideration, and it is a big one. The budget deficits are compounding and shooting skyward as is the total deficit. This tells me that in due time taxes on both corporations and individuals will be raised. Most people do not realize it, but for every $1 the Treasury takes from business, it takes $4.3 from individuals. And that tells me that the real money (for future taxes) must come from the individuals. Why? Because that's where the real money is–in individual incomes.

Conclusion: The individual and corporate tax will probably be higher eight years from now than it is today. In other words, Muni bonds will probably be MORE attractive from the standpoint of savings eight years from today than they are now.

(8) Question: Couldn't the Government kill the Muni tax benefits? The answer is that the Government can do anything as long as it doesn't foment an internal revolution (in which case the Government defeats its own purpose). BUT, a taxing of Muni's would create chaos in city, county and state financing. Muni taxes could happen, but even if they did I would think that older Muni's would be "grandfathered" (i.e., the new tax law would NOT apply to them). And that, in a few pages, is why I like Muni bonds here–at these current yields.

VACATION: I took my first full week vacation in twenty-five years. Well, it wasn't a full week, because on Friday, March 23, I went down to Maryland to do the Wall Street Week show. I spent Monday through Thursday in my home town of New York, and happily the visit was wedged between two snowstorms (we had four good days of weather). The following are some of my observations:

(1) I felt the level of crime, violence, fear, and loathing had dropped considerably. We rode the subway down to SoHo and the Village. We walked all over the City, from Madison Avenue to Broadway, from Times Square to Central Park. At no time did I feel (as I did five years ago) that I might just have to fight for my life.

(2) We stayed at the Helmsley Palace Hotel. It's a great hotel, and the service is excellent. The elevators are speedy, and we never waited for a thing. Leona Helmsley (undoubtedly the current Queen of New York) keeps the place spotless and efficient. It's expensive but I recommend it.

(3) The new Trump Tower building is one of the most opulent edifices I've ever seen. They must have 50 million dollars worth of marble in the unbelievable four story lobby of the Trump; the building is a "must see."

(4) We saw the great Picasso exhibit at the Guggenheim. For art, there is no city in the US that touches NY. Walking up Madison Avenue and through SoHo was a pleasure. The art galleries are everywhere.

(5) NYC also has (without a shadow of a doubt) the best restaurants in the Nation. We hit Cote Basque, Four Seasons, Elio's, Primavera, and I only gained three pounds total. We also went to Cafe Central on Columbus Avenue, which is probably the most exciting restaurant-bar-people watching place in the City. It is part-owned by Peter Weller (good friend of Betsy Russell, my daughter) and we had a great time talking to Peter about jazz, food, acting, Hollywood, etc.

(6)The shopping in NYC is unparalleled. Madison Avenue has become totally international with the Italians now taking over. Columbus Avenue (a slum in my boyhood days) is now "where it's happening," and it has become a place of endless trendy shops and restaurants (don't miss Columbus if you go to NY).

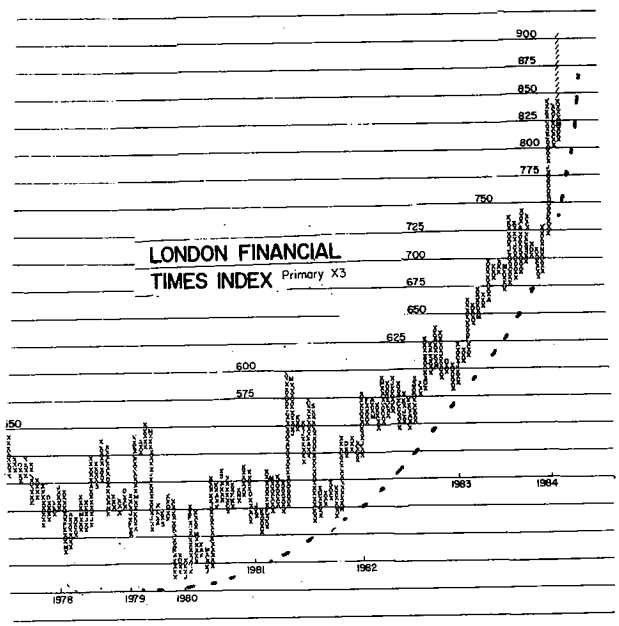
(7) Now the sad part: evidently welfare or soup kitchens have been cut way down in the City. The result is that you see vagrants, alcoholics, crazies, down-and-outers and bag ladies all over NY. They sleep everywhere–in the corners of buildings, on top of subway gratings (where the rising hot air keeps them warm). They line some streets, and they are reminders of that unhappiness and tragedy that can befall men and women (and for the grace of God, you and I).

(8) And a final observation. There is no question about it, NYC is one tough place to live. You can see it on the people's faces, you can see it in the rushing and pushing and shoving, you can see it in the lack of politeness. You can see it in the fact that people look past you in NY, not at you. It is as if New Yorkers have to filter out 75% of what's going on, from the sirens to the screaming, from the taxis honking (incessantly) to the sound of the street construction crews. It's a great city, but I can only take about four days of it. Then it's back to God's country and the West. Here's my appraisal: "In the East money and status rule, in the West sex and climate rule." That's why Wall Street is in New York and Hollywood is in California.

NOTES & QUOTES: I heard the Democratic candidates debate last night. I don't know, I'm not wild about Ronnie, but "gimme a break." Jackson talks about power to the poor, Hart tells us that we have to rebuild America from the bottom up, the highway, the sewer systems, the whole "infra-structure." And Mondale kept looking at Hart and repeating, "Where's the beef?" "Good Lord," I ask myself, "is the US fated to survive?" These guys are still talking about spending and giving more power to the people. And Ronnie keeps running deficits. We need to run Scrooge for President–or King Midas. But where are they?

* *

Jolly England: The British market has been rising in an exponential curve. The Financial Times Index is now at the vertical stage–going straight up. This is always dangerous, and that's what happened to gold in 1980. This kind of upside blow-off is often followed by a crash and a long-term top-out. So let's keep our eyes on England (chart courtesy of Market Charts, 20 Exchange Place, NYC 10005).



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I received a lot of comment about the section of the last Letter which dealt with the "whys" and "whats" of pension funds and IRA accounts. The stock market is an amazing paradox now. The fact is that the S & P Industrials are now selling at about a 40% DISCOUNT from actual replacement value. On that basis, stocks are cheap. But Barron's Bond/Stock Ratio shows that stocks are near their highest over-valuation level in history *compared with bonds.* The ratio is now 130, well above even the ratio peak of the year 1929.

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The latest US trade balance shows a deficit of over $10 million for February, a record. On this basis the annual trade deficit is going to top $100 billion. What this means is that the US just isn't selling much overseas, while every other item we buy here is made somewhere else. Check it yourself. Next time you make a purchase (except for food) look at the label. If it isn't manufactured in Hong Kong, Japan, Italy or some other overseas port, well–surprise. Americans are building houses and eating a lot of cholesterol, but foreigners are selling the goods. When that happens, "something is gonna give."

* *

Contrary Opinion: Contrary opinion is out in the open now, and everyone is very hip and very knowledgeable about being contrary. In fact, it's getting to the point of being ridiculous. So I want to bring out one point.

When everyone and his brother holds to an OPINION about some coming event, it is reasonable to believe that the effects of that event have been discounted by the market. For instance, if everyone is talking about a boost in the discount rate, then if and when a discount rate boost arrives, the market will almost surely have discounted it.

But facts are not open to contrary opinion. For instance, the March 26 issue of Time magazine features the cholesterol story on its cover. The old adage is that when Time and Newsweek finally headline a story, the story is over. But to apply that kind of thinking to the dangers of cholesterol build-up is absurd. You can't take a contrary opinion on a scientific fact, anymore than you can say that 2 plus 2 does not equal 4 because everyone knows that fact. Remember, contrary opinion is only valid when used against widely held opinions–but it is not valid against facts no matter how well known.

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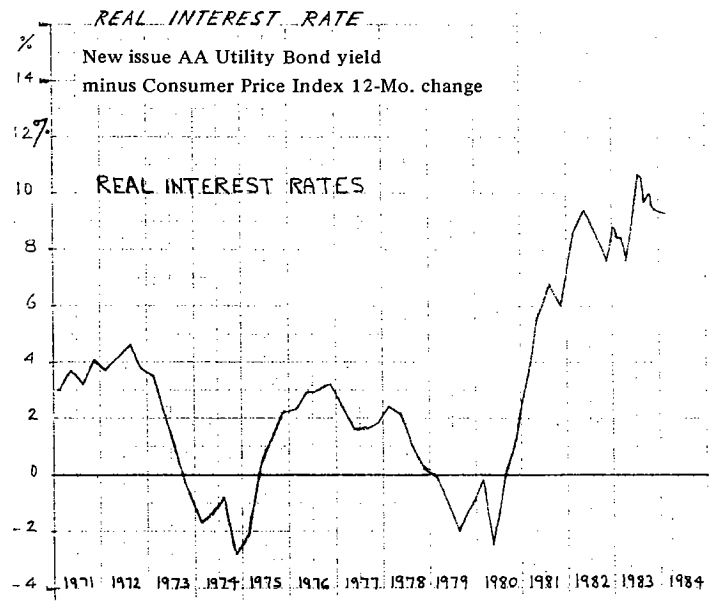
This chart of real interest rates may be "the chart of the year.". Anyway, it's telling one thing–if you've got cash (liquidity) you're in the saddle. If you've got debt, you're making the boys with the cash very rich. Ever since 1945 it's been smart to owe money. But since 1980 it's been smart to have money. This is a change brought on by the massive US debts and the beginning stages of the move from inflation towards deflation. This change is critical in everyone's investment thinking. To ignore it is to be ignorant of the tide of the 1980s (and maybe beyond).



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My buddy, Aaron Russo (he produced "The Rose" and "Trading Places"), has just finished his latest, ""Teachers" starring Nick

Nolte (for MGM). Aaron is off for a rest now in Hawaii. I can't get him down to La Jolla, he says it's too dull here (but I think it's getting too busy). I said it before and I'll say it again right here—Aaron is going to be King of Hollywood. How do I know? Like the gypsy fortune teller said, "I know theese theengs." Nah, it's my intuition.

* *

My friend, Dennis Marlowe, a professional commodities trader, publishes a report called *Marlowe's Professional Trader* (Drawer BE, Incline Village, Nevada 89450). In his latest issue, Dennis rates the various items according to their reliability as far as (technical) trading is concerned. Here's the list:

> MOST RELIABLE: Gold, Interest Rate futures, all the Grains (Corn is the best), all the Currencies, and the Stock Indexes.
> LESS RELIABLE: Silver, Copper, Sugar, Cotton, Cattle, Hogs, Platinum, Palladium and Lumber.
> LEAST RELIABLE: Coffee, Cocoa, the Petroleum group, Orange Juice, and Pork Bellies.
> Smaller accounts should confine themselves to the first group. Larger accounts can diversify down the list, but only if the risk/reward ratio justifies contending with the lower probability of success. And remember, the percentage of correct trades is unimportant if your bottom line looks good.

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There has been optimism lately based on computations that show the Federal budget running at a rate of "only" $150 billion. But James Capra (Lehman Bros.) who spent five years as chief of budget projections at the CBO says that this is simply a matter of variations in the timing of three major expenditures; Social Security Cost of Living, farm supplements and pay hikes for Federal employees. The upshot: Capra sees the deficit running at a rate of around $185 billion.

LATE NOTES: The week ending March 30 saw my 13-week moving average of the Dow drop below the 50-week MA. This usually constitutes a longer-term sell signal. On March 30 the PTI dropped to 1692, a new low for 1984. The market has worked off some of its over-sold condition, but my studies don't look too good. There's still no strength in the bond market, although the municipals are holding strongly (they almost act as if they're in a different world).

GOLD: In New York I attended a meeting of the Brinks company. Brinks announced they are going into the precious metals "business," which means that they will buy and sell gold and precious metals as well as storing it for customers (they will also ship it). With all the problems that have been hitting investors who have put money with various insolvent or kookie precious metals outfits, it is clear that Brinks is an outfit that can be trusted. So add Brinks to your list of places to buy gold and silver. If you buy enough, I have no doubt that Brinks will send an armored car to your home with your stockpile of precious metals.

As for the metal itself, that's another story. Consider this: if Argentina had defaulted on $650 million in interest say in 1980, gold would probably have jumped $75 over night. But gold did nothing in the face of last week's scare. So the sluggish (if not downright ornery) action of gold is hardly encouraging to gold-bugs.

On top of that the dollar has been weak, the US trade balance is a disaster, and who knows what comes up next in the Mid-East or in Central America (where we have lost count of the number of wars going on).

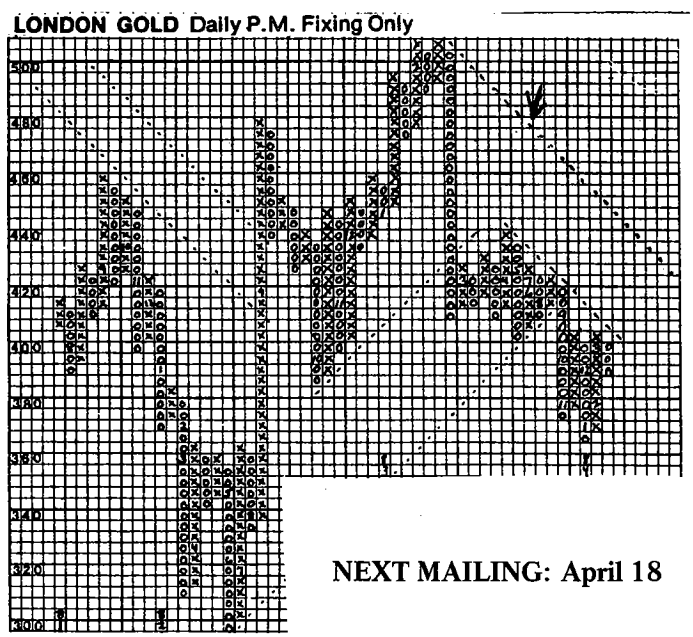
My own feeling is this (and I intend to go into the subject much more in detail in the next Letter): I think that the forces of deflation are slowly but surely overtaking the forces of inflation. Now when deflation hits, you need cash, and you need return. You need liquidity. I think that dollars returning 10% to 12% are proving irresistible to many investors and many nations. I don't think that gold is competing successfully with dollars at this time.

Remember, when massive defaults occur, money disappears—and that process is deflationary. Debts that go down the drain are deflationary, and bank stocks that sink (as many now are because huge defaults hit the bank earnings) are also deflationary.

This chart (courtesy of Chartcraft, Larchmont, NY) shows the trend of gold clearly enough. Note the main bearish trendline (arrow points to it). That trendline has been pressuring gold down ever since early 1983. A second lower bearish trendline comes in at 404. If gold can rise to 408 it will have pushed above the secondary bearish trendline, and that would be a happy occasion for goldphiles.

But all in all, the fact is that when you buy gold you are giving up around 12% in interest. In three years you are giving up 12% compounded or better than 35%. That means that gold has to rise by better than one-third just to stay even with T-bonds. Can gold do it? Maybe, but one is a guarantee and the other is a hope. It seems clear, so far, the big money is going for the guarantee. So am I.

If you must have gold, then I still say wait for a fix at 408. No 408—then sit tight with the greenbacks. That's the way I see it, and I used to be the biggest gold-bug around, remember!



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